The Bankrupt Sovereign

The Sovereign Debt Restructuring Mechanism (SDRM)

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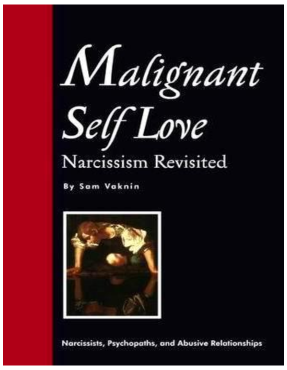
Also published by United Press International (UPI)



Written January 24, 2003

Updated April 2005, January 2011

On January 12 and 13, 2011, Spain, Portugal, and Italy successfully sold 22 billion euros of new debt in the form of sovereign 5-year and 10-year bonds. The European Union (EU) spin-doctored the outcomes of these auctions as a great success. Actually, they came close to the brink of disaster: Spain had to pay an extra percentage point and Italy another half a percentage compared to identical obligations they had sold in November 2010. What a difference three months

make! The rising yields demanded by investors indicate a perception of the growing risk of these two not-so-peripheral members of the EU.

All the auctions ended up being mildly oversubscribed (1.4-2 times the supply on offer). But, this is highly misleading: only 40% of the bonds were purchased by commercial investors. The rest were bought by the governments of China and Japan and by the ECB itself! Put bluntly: the auctions were rigged. China extracted an onerous price for its relatively moderate commitment in the form of technology transfer commitments and a further relaxation of EU trade protections.

Alarmed by the results, the beleaguered President of the ECB, Jean-Claude Trichet, lobbied even harder for a sizeable increase in Europe's rescue (read: bailout) fund and in the European Stabilization Mechanism. He was instantly rebuffed by the Germans, but realities being the way they are, the ECB is likely to prevail and, in the process, become the largest owner of sovereign bonds of illiquid and insolvent member states. This development is the most alarming: in the absence of a liquid, politically-independent and functional central bank, the euro project is all but doomed.

In a little noticed speech, given in January 2003 at an IMF conference in Washington, Glenn Hubbard, then Chairman of President Bush's Council of Economic Advisers, delineated a compromise between the United States and the International Monetary Fund regarding a much mooted proposal to allow countries to go bankrupt.

In a rehash of ideas put forth by John Taylor, then Treasury Undersecretary for International Affairs, Hubbard proposed to modify all sovereign debt contracts pertaining to all forms of debt to allow for majority decision making, the pro-rata sharing of disproportionate payments received by one creditor among all others and structured, compulsory discussions led by creditor committees. The substitution of old debt instruments by new ones, replete with "exit consents" (the removal of certain non-payment clauses) will render old debt unattractive and thus encourage restructuring.

In a sop to the IMF, he offered to establish a voluntary sovereign debt resolution forum. If it were to fail, the IMF articles can be amended to transform it into a statutory arbiter and enforcer of decisions of creditor committees. Borrowing countries will be given incentives to restructure their obligations rather than resort to an IMF-led bailout.

In conformity with the spirit of proposals put forth by the Bank of England and the Bank of Canada, Hubbard insisted that multilateral financing should be stringently conditioned on improvements in public sector governance and the legal and regulatory frameworks, especially the protection of investor and creditor rights. He

rejected, though, suggestions to strictly limit official financing by international financing institutions.

Yet, these regurgitated schemes suffer from serious flaws.

It is not clear why would creditors voluntarily forgo their ability to extort from other lenders and from the debtor an advantageous deal by threatening to withhold their consent to a laboriously negotiated restructuring package. Nor would a contractual solution tackle the thorny issues of encompassing different debt instruments and classes of creditors and of coordinating action across jurisdictions. Taylor's belated proviso that such clauses be a condition for receiving IMF funds would automatically brand as credit risks countries which were to introduce them.

The IMF is, effectively, a lender of last resort. When a country seeks IMF financing, its balance of payments is already ominously stretched, its debt shunned by investors, and its currency under pressure. The IMF's clients are illiquid (though never insolvent in the strict sense of the word).

The IMF's First Deputy Managing Director, Anne Krueger, proposed in November 2001 to allow countries to go bankrupt within a Sovereign Debt Restructuring Mechanism (SDRM). Legal action by creditors will be "stayed" while the country gets its financial affairs in order and obtains supplemental funding. Such an approach makes eminent sense.

Today, sovereign debt defaults lead to years of haggling among bankers and bondholders. It is a costly process, injurious to the distressed country's future ability to borrow. The terms agreed are often onerous and, in many cases, lead to a second event of default. The experiences of Ukraine and Ecuador in the 1990s are instructive. Russia - another serial debt restructurer, lastly in 1998 - was saved from a recurrent default by the fortuitous surge in oil prices. Argentina and its emasculated debtors were not as lucky.

Moreover, as Hubbard observed in his speech, both creditors and debtors have a perverse incentive to aggravate the situation. The more calamitous the outlook, the more likely are governments and international financial institutions to step in with a bailout package, replete with soft loans, debt forgiveness and generous terms of rescheduling. This encourages the much-decried "moral hazard" and results in reckless borrowing and lending.

A carefully thought-out international sovereign bankruptcy procedure is likely to yield at least two important improvements over the current mayhem. Troubles now tackled by a politically-compromised and bloated IMF will be relegated to the marketplace. Bailouts will become rarer and far more justified. Moreover, the "last man syndrome", the ability of a single creditor to blackmail all others - and the debtor - into an awkward deal, will be eliminated.

By streamlining and elucidating the outcomes of financial crises, an international bankruptcy court, or arbitration mechanism, will, probably, enhance the willingness of veteran creditors to lend to developing countries and even help attract new funding. The creditworthiness of lenders increases as procedures related to collateral, default and collection are clarified. It is the murkiness and arm-twisting of the current non-system that deter capital flows to emerging economies.

Still, the analogy is partly misleading. What if a developing country abuses the bankruptcy procedures? As The Economist noted wryly "an international arbiter can hardly threaten to strip a country of its assets, or forcibly change its 'management'".

Yet, this is precisely where market discipline comes in. A rogue debtor can get away with legal shenanigans once - but it is likely to be spurned by lenders henceforth. Good macroeconomic policies are bound to be part and parcel of any package of debt rescheduling and restructuring in the framework of a sovereign bankruptcy process.

Addendum - Vulture Funds

Vulture funds are financial firms that purchase sovereign debt at a considerable disaggio and then demand full payment from the issuing country. A single transaction with a solitary series of heavily discounted promissory notes can wipe out the entire benefit afforded by much-touted international debt relief schemes and obstruct debt rescheduling efforts.

Addendum - Nationalizing Risk

During the months of September-October 2008, governments throughout the world took a series of unprecedented steps to buttress tottering banks. In the USA, the Federal Reserve and the Treasury Department have flooded the financial system with liquidity; granted commercial banking licenses to the few investment banks left standing; lent funds against financial instruments turned toxic; and purchased non-voting equity and senior debt in a host of firms and banks. Several European countries have guaranteed all bank deposits and short-term interbank loans.

These steps served to halt the panic at least temporarily and have thus prevented runs on banks and the seizing up of the credit markets. Still, these were mere palliatives. They did not tackle the roots of the crisis, though they averted it.

Instead of eliminating risky, ill-considered investments and bad loans by allowing defaults and bankruptcies, governments have shifted debts and risks from financial institutions to taxpayers and sovereigns. The question was thus no longer: will this or that bank survive, but: will this or that country remain solvent. Iceland, for

instance, essentially went belly up. Other countries, including the USA, are liable to pay for this largesse with a bout of pernicious inflation.

And even as the United States begins its long recovery, Europe and Asia are left to bear the brunt of American profligacy, avarice, regulatory dysfunction, and shortsightedness. According to a research note published by Credit Suisse, the Baltics, Bulgaria, Ukraine, Romania and Hungary "face many of the same macro-economic strains as Iceland, with deep balance of payments deficits and a high ratio of private sector credit to GDP". To these one can add South Africa.

Shifting risk from the private sector to the public one and from one locale (the USA) to others (Europe, Asia) are not long-term solutions. They only postpone the inevitable. The imbalances in the international financial system are such that unwinding them requires a prolonged and painful global recession. In economics, there is no free lunch.

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